



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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Chief Administrative Officer

March 1, 2011

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2010. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan. There were approximately 5,650 active members and 5,700 retirees participating in the ERS as of December 31, 2010.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 5.62%, 110 basis points ahead of the 4.52% gain recorded by the policy benchmark. For the one year period ending December 31, 2010 the ERS' gross return (before fees) was a gain of 14.26%, 150 basis points ahead of the 12.76% gain recorded by the policy benchmark. The one-year return, after fees, places the ERS' performance just below median of a universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a gain of 1.64%, after fees, ranking in the top third of the universe and the five-year return, a gain of 5.36% ranked in the top 10%. The asset allocation at December 31, 2010 was: Domestic Equities 27.4%, International Equities 18.3%, Fixed Income 24.7%, Inflation Linked Bonds 10%, Commodities 5.6%, Private Equity 6.7%, Private Real Assets 3.4%, Opportunistic 2.9%, and Cash 1%. We estimate that the funded status of the ERS was 77.8% as of December 31, 2010, a slight increase from the June 30, 2010 level. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

Major Initiatives

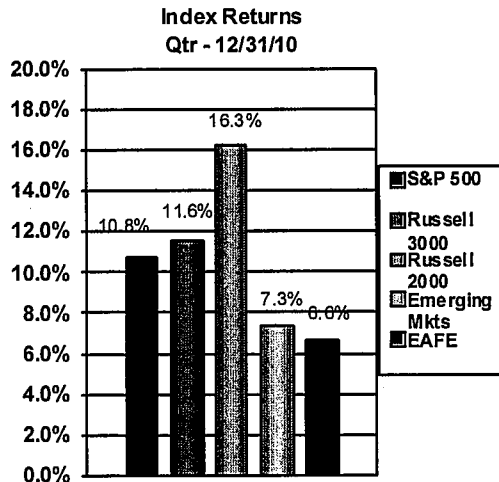
During the quarter, the Board approved proposed changes to the ERS assumptions and methodologies used in the calculation of the annual required contribution and funded status of the Plan. In addition, the Board approved changes to the Rebalancing Policy including adding sub-asset class bands around each sector's target allocation.

Capital Markets and Economic Conditions

Real GDP came in at 2.6% for the September quarter and the current quarter is on track to reach a more robust 3.0% to 3.5% growth rate. Although GDP growth still remains below historical recovery periods, this level of expansion would allow or improvement in the unemployment and contribute to a sustainable recovery. The unemployment rate decreased slightly for the quarter and we are seeing trends, like initial jobless claims improving. Consumer spending picked up, primarily during the holidays, most notably in auto sales.

This quarter's housing data continues to display weakness largely due to seasonal factors and foreclosure delays. Unless the job market improves, or the home-buyer tax credit is reinstated, a housing market recovery seems unlikely in the near-term. With 5 to 8 million existing homes in inventory, and higher mortgage rates, it is unlikely that sales will recover significantly.

Public Equity Markets: The U.S. equity markets rallied strongly during the fourth quarter on the Fed's long-anticipated announcement related to additional quantitative easing (QE2) to stimulate the economy and improved economic news easing investors' fear of a double-dip recession. All major domestic

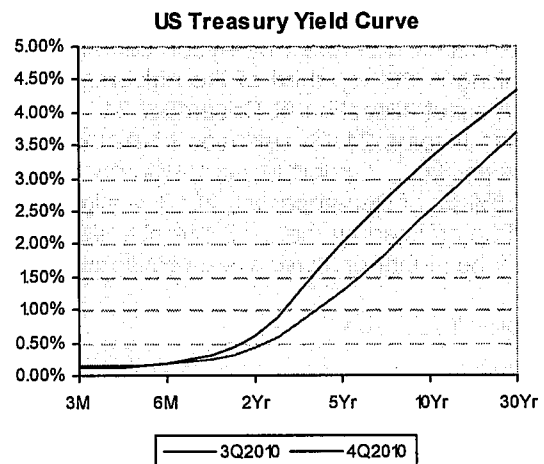


indexes participated in the rally as shown in the chart to the left with smaller capitalization stocks outperforming their larger counterparts. All sectors of the S&P 500 posted positive returns during the quarter with cyclical sectors – Energy, Materials, Industrials – advancing the most. Our combined domestic equity performance was a gain of 12.75%, outperforming the 11.59% gain recorded by the Russell 3000 benchmark.

Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were up 6.61% advancing on stronger economic data and the QE2 despite further concerns over the European sovereign debt. Emerging markets gained 7.34% during the quarter benefiting from strong regional performance in the emerging markets in the Middle East, Africa, and Eastern Europe while the emerging Asian markets were held down by China's weak performance. Our combined international equity

performance was a gain of 6.38% for the quarter, underperforming the 7.20% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: Treasury yields rose during the fourth quarter but ended the year lower than where they started. Better economic data, the extension of the Bush tax cuts and the Fed's announcement to purchase \$600 billion in Treasury bonds moved yields higher. The Fed maintained its target rate at a 0% - 0.25% range while reiterating its view that current economic conditions warrant exceptionally low levels for an extended period. The yield curve (shown in the chart to the right) steepened as the 2 year Treasury bond rose 17bps to 0.60% while the 10 year Treasury bond rose 79 bps to 3.29%. Credit spreads tightened over the quarter, led by high yield, and the credit curve flattened as investors moved out in duration to pick up additional yield. For the quarter, the Merrill Lynch High Yield Master II Index rose 3.07% while the Barclays Aggregate Bond and the Barclays Long Govt/Credit Indexes declined by 1.30% and 5.60%, respectively. Our combined fixed income performance for the quarter was a loss of 0.45bps, outperforming the custom benchmark which lost 1.74%. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 3.16% for the quarter, compared to the 1.53% loss recorded by the benchmark.



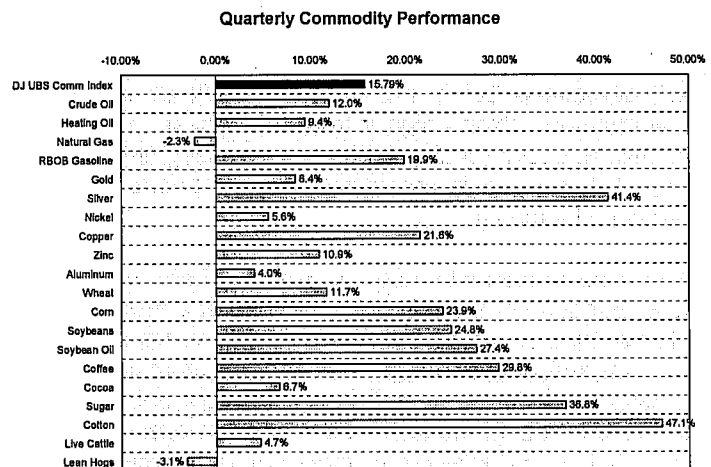
Private Equity: The fourth quarter saw significant increases in private equity activity with both new investments and exits at their 2010 peak. Factors contributing to the higher activity include an improved lending environment, greater confidence in the economy, and a year-end push to complete deals under the then-current tax regime. However, fundraising remains challenging, which points to diminished competition for deals in the coming years. During the quarter, our private equity managers called a combined \$13.8 million and paid distributions of \$5.5 million. Our current allocation to private equity is 6.7%, with a market value of \$184.7 million. From its 2003 inception through September 30, 2010, the

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private equity program has generated a net internal rate of return of 3.5% versus a 3.3% return for the dollar-weighted public market equivalent (the Russell 3000 plus 300 basis points).

Private Real Assets: The Moody's/REAL U.S. Commercial Property Price Index rose during the fourth quarter, moving off of an eight-year low reached during the third quarter. Real estate transaction activity was also strong for the quarter, propelling global investment activity to its best year since 2007. Unlike earlier in the recovery, the U.S. was a significant contributor to growth in deal volume though much of this activity was concentrated with "trophy" properties in select major markets, including New York, Washington, DC, and San Francisco. In energy investing, deal activity was also robust, as companies continue to reposition themselves to move into unconventional fuel investments by selling off conventional assets. During the quarter, our managers called a total of \$12.1 million and paid distributions of \$0.6 million. Our current allocation to private real assets is 3.4%, with a market value of \$94.2 million. From its 2006 inception through September 30, 2010, the private real assets program has generated a net loss of 14.5% versus a 14.9% loss for a comparable index (the Moody's/REAL U.S. Commercial Property Price Index).

Commodities: The DJ UBS Commodity Index rallied 15.79% during the quarter driven by strong demand in China and tight supply conditions. All major sectors were up, lead by the softs and agriculture sectors. On an individual commodity level, cotton surged 47.1% as adverse weather damaged global crops and demand surged in China, the world's largest consumer. Sugar advanced 36.8% on speculation that global supplies will fall short of consumption. Precious metals joined the rally with silver posting a 41.4% as debt concerns in Europe and purchases for the holiday season in Asia boosted demand. All industrial metals, led by copper, benefited from the ongoing global demand. Crude oil advanced along with the broad based commodities rally reaching a new high in 2010. During the quarter, our commodities portfolio advanced 15.79%, in line with the 11.61% gain recorded by the DJ UBS Commodities Index.



Additions

The primary sources of additions for the ERS include contributions from members and employers and investment income. The following table displays the source and amount of additions for the quarter ending December 31, 2010 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr 12/31/2010	Fiscal YTD
Employer Contributions	\$ 29.7	\$ 59.9
Member Contributions	4.9	9.5
Net Investment Income	139.3	342.7
	<u>\$ 173.9</u>	<u>\$ 412.1</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

**Employees' Retirement System
Deductions by Type (millions)**

	Qtr 12/31/2010	Fiscal YTD
Benefits	\$ 44.6	\$ 88.8
Refunds	0.4	0.9
Administrative Expenses	0.8	1.3
	<u>\$ 45.8</u>	<u>\$ 91.0</u>

Outlook

Overall US inflation remains low, however, the downward pressures on price levels that produced sub 1% inflation rates in the US are gradually abating. One of the indirect consequences of the Fed's easing policy is an increase in inflation, particularly in global commodities like oil and metals. These price increases will put pressure on the costs of manufacturing goods and ultimately the profit margins at companies. Likewise, the rising price of oil and gasoline will hamper consumer spending. Employment is still depressed but is not quite as weak as it had been, and there are some signs that wages are stabilizing or moving higher from a low base. Businesses have made significant adjustments in terms of excess capacity (cutting labor and investing little) and are facing strong demand growth. Housing prices have ticked lower in recent months, but prices have been roughly stable for over a year, and rents are edging a bit higher.

The main reason why employment has been mediocre has been the weak hiring rate and not the firing rate. Because of the difficult labor market a greater share of fired workers are filing for claims making the claims number higher than it was a few years ago. The hiring rate has improved slightly off of lows, but remains weak and roughly unchanged in recent months. A low hiring rate explains why employment growth is mediocre despite the firing rate being low. Employment measures are lagging the pickup in demand in recent months, which is fairly normal. We expect strong employment growth in months ahead, though it will still take many years before unemployment rates are normalized.

At some point the massive purchase of government debt by the Fed will have to be removed and replaced by private market investments. How smoothly this transition occurs will have an impact on markets. Most economists believe the Fed will continue purchasing the debt into 2012 but if the economy continues to strengthen the Fed's easing could end sooner.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**
December 31, 2010

Assets

Equity in pooled cash and investments	\$ 1,176,936
Investments:	
Northern Trust	2,741,710,684
Aetna	14,979,966
Fidelity - Elected Officials Plan	758,686
Fidelity - DRSP	6,968,516
Total investments	2,764,417,852
Contributions receivable	5,403,815
Total assets	2,770,998,603

Liabilities

Benefits payable and other liabilities	7,276,877
Net assets held in trust for pension benefits	\$ 2,763,721,726

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
 December 31, 2010

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 29,703,945	\$ 59,854,306
Member	<u>4,850,277</u>	<u>9,490,652</u>
Total contributions	<u>34,554,222</u>	<u>69,344,958</u>
Investment income	146,295,426	353,884,900
Less investment expenses	<u>6,997,339</u>	<u>11,147,983</u>
Net investment income	<u>139,298,087</u>	<u>342,736,917</u>
Total additions	<u>173,852,309</u>	<u>412,081,875</u>
Deductions		
Retiree benefits	32,466,377	64,703,769
Disability benefits	10,104,855	20,208,885
Survivor benefits	2,019,196	3,926,486
Refunds	409,443	889,511
Administrative expenses	<u>760,219</u>	<u>1,323,821</u>
Total deductions	<u>45,760,090</u>	<u>91,052,472</u>
Net increase (decrease)	<u>128,092,219</u>	<u>321,029,403</u>
Net asset held in trust for pension benefits		
Beginning of period	<u>2,635,629,507</u>	<u>2,442,692,323</u>
End of period	<u><u>\$ 2,763,721,726</u></u>	<u><u>\$ 2,763,721,726</u></u>